

**From:** Glenn Cogswell (TAX) <glennkog@microsoft.com>  
**Sent:** Tuesday, December 21, 2004 12:24 AM  
**To:** George, Gregory L  
**Cc:** Weaver, Brett A  
**Subject:** FW: Draft powerpoint  
**Attachments:** PR Cost Sharing 122004 draft.ppt

**Importance:** High

I have some edits and I have also changed the order. I'll call you to discuss.

-----Original Message-----

From: George, Gregory L [<mailto:glgeorge@kpmg.com>]

Sent: Monday, December 20, 2004 12:00 PM

To: Glenn Cogswell (TAX)

Cc: Weaver, Brett A; Sample, Bridget M

Subject: Draft powerpoint

Importance: High

Glenn,

Please review the draft powerpoint presentation. Currently slide 6 has no information. May need to get this from ops group.

The benefits numbers changed slightly from our last meeting on November 5th.

This was due to updates for transfer pricing assumptions based on input from Nancy and David.

<<PR Cost Sharing 122004 draft.ppt>>

Gregory L. George

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Our advice in this communication is limited to the conclusions specifically set forth herein and is based on the completeness and accuracy of the above-stated facts, assumptions and representations. In rendering our advice, we are relying upon relevant authorities that are subject to change, sometimes retroactively. We will not update our advice for subsequent changes to authorities or interpretations thereof.

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**Government  
Exhibit**

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## Planning Alternatives in Puerto Rico

December 21, 2004



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### Puerto Rico – Proposed Operational Changes

**Current Operating Model:**

- MS Puerto Rico supplies Microsoft with 50 to 60 percent of the CDs manufactured for retail sales into the Americas region.
- MSPR produces almost exclusively Office and Windows products.
- MSPR produces FPP, Open, Select and EA CDs
- A third party vendor packages the CDs for sale and delivery to the customer

**Proposed Operating Model:**

- MS Puerto Rico will increase their manufacturing capacity in order to supply 100% of the CDs / DVDs for all retail sales in the Americas for the following business units:
  - Client (Non-OEM)
  - Information Worker (Non-OEM)
  - Server & Tools (Non-OEM)
  - MBS

MSPR will produce FPP, Open, Select and EA CDs:

- No change to the customers interface with Microsoft



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**Puerto Rico – Americas Retail Revenue**

FY 04 Americas Retail Revenue derived from CDs/DVDs  
Manufactured in Puerto Rico

- Client (excludes OEM) \$4.986 billion
- Information Worker (excludes OEM) \$2.590 billion
- Server & Tools (excludes OEM) \$2.408 billion
- MBS \$0.347 billion

Total \$10.331 billion

\* FY04 OEM revenue backed out pro-rata from Client, IW and S&T numbers



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**Puerto Rico – Estimated Benefits**

Estimated tax benefits under current tax law over a ten year period results in the following:

- NPV Cash Tax Savings over 10 Yrs: \$2.658B
- ETR Percentage Points Reduction: -2.98%
- Earnings Per Share Increase: \$0.12



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**Continuing Operations in Puerto Rico - Advantages**

**Why Now?**

- US tax deferral may partially offset foregone Sec. 936 tax credit and FSC/EIE
- Most companies have or are in the process of replacing Sec 936 benefit with similar deferral structures
- Other priority tax projects are now completed
- Greater predictability with respect to equity compensation



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### **Puerto Rico – Key Modeling Assumptions**

The benefits modeled are based on the following key assumptions:

- Technology IP Assumptions
  - Average Life of IP shifted is 4.5 years with a 5 year tail
  - Includes a product lag time to market of 6 months
- The Buy-In calculations is based on the following residual profit split
  - 55% Technology
  - 45% Marketing
- All Technology profit is shifted to Puerto Rico. All marketing profit remains in the US
- Overall modeling approach is conservative
- Revenue and expense projections provided Microsoft planning group



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### Puerto Rico – Operational Costs

#### Incremental Costs with full implementation of Plan:

- |   |      |
|---|------|
| • Capital Investment in Machinery & Equipment           | \$XX |
| • Implementation Costs                                  | \$XX |
| • Redundant / Back-up Manufacturing Strategy            | \$XX |
| • Business Risks (i.e., quality, back-up plan strength) | \$XX |



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### **Puerto Rico – Transactional Model and Tax Strategy**

#### **Current Financial Model:**

- Microsoft pays MS Puerto Rico for CDs produced at media carrying value (assume .50 cents per CD)
- Financial benefit is derived through §936 tax credit given for property manufactured in Puerto Rico
- Benefit will expire at the end of FY06

#### **Proposed Financial Model:**

- MS Puerto Rico acquires exclusive license to manufacture software media for the Americas retail market
- MS Puerto Rico enters into an R&E cost sharing arrangement with MS Corp
- MS/MSLI pays MSPR for CDs/DVDs at a value equal to the FMV of software technology (assume \$80 per FPP CD/DVD)



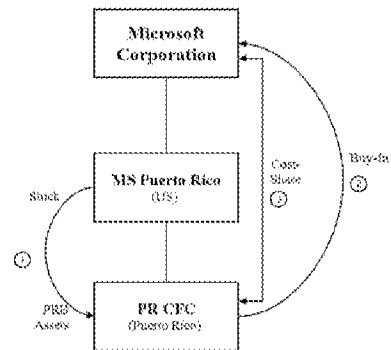
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### Proposed Legal Structure -- Puerto Rico CFC

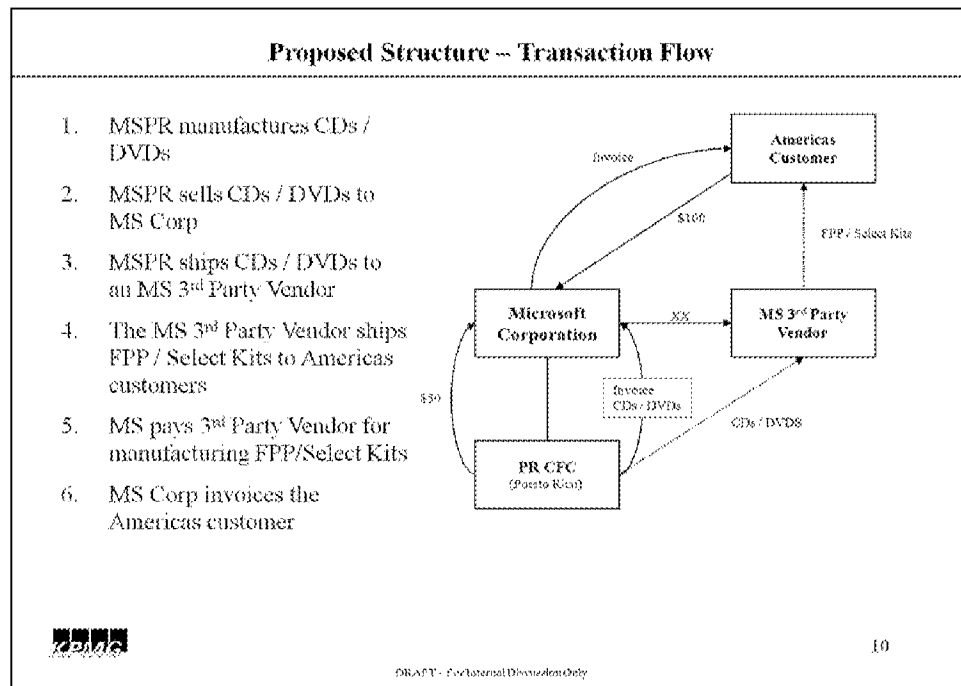
#### Steps:

1. MS Puerto Rico (or MS Corp) contributes the assets of PRB tax-free to a new Puerto Rico company, PR CFC, in exchange for stock.
2. PR CFC buys-in to the existing technology intangibles with respect to the software products that it manufactures.
3. PR CFC and MS Corp enter into a cost-share arrangement with respect to future developed intangibles.
4. PR CFC may either adopt the existing tax arrangement, or apply for a new agreement with the Puerto Rican taxing authorities for a tax holiday in Puerto Rico. PR CFC should be taxed on its profits in Puerto Rico at a rate of 2% to 7%, depending on size of operations and profit projections, for a period of 10 to 20 years.



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### **Puerto Rico – Tax Risks**

#### **Tax Risks and Tax Mitigation Strategy:**

- **Subpart F**
  - Full Direct Manufacturing of Software Media in PR
  - Utilize MSPR's own employees
  - True sales office for customers in PR
- **ECI**
  - Leave marketing intangible in the US
  - True sales office for customers in PR
  - Accepting / Concluding contracts in PR
  - Passing Title outside the US
- **Transfer Pricing**
  - Develop strong documentation around contentious issues (i.e., Life, Lag, Rate of Decay of transferred IP)



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### **Puerto Rico Local Country Tax Issues**

Negotiations with Puerto Rico government regarding the following key issues:

- New entity will receive a reduced tax rate of 2%
- Minimize/eliminate withholding taxes on royalties
- Negotiate zero rate on unwind if necessary



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### Financial Statement and Treasury Issues – Puerto Rico

- How does this new structure effect Microsoft's ETR?
  - During the first few years Microsoft's US current tax liability is increased due to the buy-in and cost-share payments
  - Can Microsoft book a deferred tax asset to offset the current tax liability?
  - Appears to be very limited circumstances to book a deferred tax asset.
  - Tax department and corporate accounting still reviewing
- Funding the Puerto Rican Operations Company
  - MS Puerto Rico's initial losses should be funded out of US
  - Funding will come back to US via Cost Share-Buy In payments
  - Once cash-flow positive, cash invested through MGFL
  - Debt versus Equity



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**Puerto Rico – Other Issues**

- Early buy-in
- Unwind Strategies
- Operational issues
  - Securing plant and equipment
  - Hiring qualified personnel in PR
- Accounting and IT Systems



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